BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

APRIL 1950

Summary

At the beginning of 1950 Seventh District banking as an institution was bigger than ever before. In nine important categories—total earning assets, gross earnings, operating expenses, net operating earnings, time deposits, total deposits, consumer loans, real estate loans, and holdings of non-Government securities — Seventh District member banks on December 31, 1949, reported the highest figures in their history.

Yet banking developments during the postwar period were varied and divergent. Commercial loans expanded sharply during the first few postwar years, but have declined considerably over the past 18 months. Consumer and real estate loans increased rapidly throughout most of the postwar period, slowing only during 1949. Farm loans, meanwhile, grew most rapidly during the last two years, largely because of the rapid increases in Federally-guaranteed crop loans.

At the same time, Federal policies, directed first against inflation, then against recession, had a substantial effect upon the balance sheets of District banks. Anti-inflationary credit action by the Federal Reserve and the Treasury reduced total bank earning assets and total bank deposits during the postwar inflation. A reversal of such policies facilitated the substantial increase in bank assets and deposits during the 1949 recession.

Postwar asset and liability changes were not spread evenly throughout the Seventh District banking system. Country banks effected a large and steady loan expansion and consequent liquidation of Government securities holdings. The loan expansion in larger banks was smaller and less sustained. In addition, metropolitan banks absorbed the major portion of the substantial changes in assets and liabilities engendered by Federal Reserve and Treasury action. As a result, total loans and investments of country banks increased 14 per cent during the postwar period, while the earning asset holdings of central reserve city banks were declining 9 per cent. This divergent asset trend produced a corresponding deviation in earnings. Expansion of high-yield loans helped increase country banks' net operating earnings 66 per cent during the years since the war. Central reserve city banks, on the other hand, suffered a 9 per cent reduction in net current earnings over the period.

The typical District bank was able to increase its "profitability" by 20 per cent between 1945 and 1949; but the diametrically opposed experience of metropolitan and rural banks which is hidden behind this and other averages is one of the most important developments in postwar District banking.

POSTWAR SEVENTH DISTRICT BANKING

Postwar Seventh District Banking

Rural Banks Lead Big Banks In Postwar Boom

The year 1949 marked the end of an important period for our domestic economy. From the end of the war in 1945 through 1948 the United States was caught up in a postwar boom which set all-time records in civilian production, in money income, and, for certain segments, in peacetime price rises. The modest decline in almost all phases of economic activity which occurred during 1949 is a mild but nonetheless definite sign of the end of that period in which adjustments to wartime economic and monetary developments dominated the domestic economy. The year 1950 may well begin a decade in which the nation will go on to even higher levels of activity, but the pressures of war-born "backlogs," "shortages," and "distortions" will not play an important role in such development. The future course of business will be rooted in a new and different economic base.

The end of such a period is an appropriate time for review of the changed position of the various sectors of the domestic economy. Such consideration is especially important in banking, for the magnitude of financial changes wrought in the war and postwar periods necessitated an unusual degree of adjustment within the monetary system. In addition, banking is a dependable reflector of economic conditions in general, and developments in banking often give indications of regional business changes which are otherwise difficult to discover.

Accordingly, this entire issue of *Business Conditions* has been devoted to a consideration of postwar banking trends within the Seventh District. In banking, as in business generally, the best understanding of the outlook for the future is based upon an accurate perspective toward the experience just past.

TRENDS IN LOAN AND INVESTMENT PORTFOLIOS

The course of Seventh District banking during the postwar boom hinged upon the strong upsurge in bank lending. An initially strong but gradually slowing expansion in almost every type of bank lending to the public increased net loan totals of Seventh District member banks by 1.8 billion dollars, or 65 per cent, from the end of 1945 to the end of 1948. Over the same period liquidation of Government securities holdings to provide loan funds and to meet the anti-inflationary pressures of monetary and fiscal authorities reduced member banks' portfolios of Governments by three billion dollars, or 25 per cent.

In contrast, after the moderate decline and mild recovery of 1949, District member bank loans stood at 4,557 million, exactly equal to their end-of-year total for 1948, while bank holdings of Governments rose 1.2 billion under the eased monetary conditions then introduced. In terms of the postwar experience, therefore, total bank earning assets declined unevenly during the boom and increased substantially during the recession.

LOANS

Commercial Loans—As the largest outlet for bank loan funds, loans to commercial and industrial enterprises by Seventh District member banks at the end of 1949 totaled 2,010 million, two-thirds larger than the December 1945 volume. Business borrowing to finance postwar reconversion and expansion increased rapidly during 1946 and 1947, particularly in smaller outlying banks. In 1946 alone business loans held by banks in the "country" bank classification increased 70 per cent. As inflationary prosperity continued, however, business borrowing slowed appreciably. By the end of 1948, debt repayments by larger enterprises had already slightly reduced the total of commercial loans held by central reserve city banks, and in the ensuing six months this trend was intensified and spread throughout most of the banks in the Seventh District. The weak recovery in business loans during the fall of 1949 erased only 37 million of the 309 million decline which occurred during the first half of that year.

During the past year the combination of high profits and finished or curtailed capital and inventory expansion enabled many businesses to devote funds to repayment of bank debt. Because this was particularly true of big businesses banking with the District's larger institutions, the business loans of central reserve city banks declined 14 per cent during 1949, almost twice as sharp a drop as that experienced by the remaining banks in the District. This drop-off in loans to business was not due to tightened credit and pressures for liquidation, but was largely the result of a shrinking demand for credit. Such a development confirms other indications that businessmen, for the near future at least, are planning to operate with a smaller volume of bank-supplied working capital.

Agricultural Loans—Bank loans to farmers are naturally concentrated almost entirely in the District's 916 country banks. As of December 31, 1949, non-real-estate loans to farmers comprised one-eighth of the aggregate country bank loan portfolio. Increases in this type of lending have not provided the largest or most rapid additions to country bank earning assets, but a steady growth in demand for short-term farm credit has continued throughout the postwar period.

The conventional type of privately secured non-real-estate loans to farmers held by District member banks

totaled 172 million dollars at the end of 1949, 110 per cent above the figure for December 1945. Such loans grew substantially in each year from 1945 through 1948, as a gradual trend toward net increases in farmer borrowing during the usual spring "repayment period" developed alongside expanded borrowing during the late summer and fall months. In 1949, however, a reappearance of the usual spring excess of repayments, combined with a slightly smaller (22 million) fall expansion, held the annual increase to 7.5 per cent, less than a third of the previous postwar average. Indications are that this slackening rate of growth in "business" loans to farmers may be due largely to reduced buying of machinery and equipment during 1949, in the light of heavy previous purchases and the outlook both for lower equipment prices and declining farm incomes.

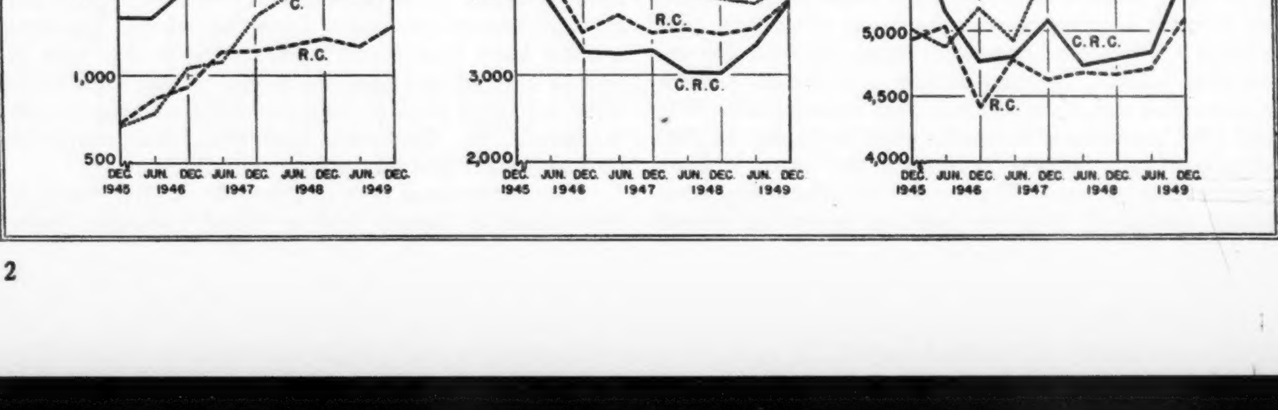
The postwar reappearance of loans on farm crops guaranteed by the Commodity Credit Corporation has added an important type of paper to country bank agricultural loan holdings. Because these loans are a basic element in the Federal farm price support program, little of this credit was extended by District banks during the early postwar period of high farm prices. Holdings of CCC crop loan paper by District banks jumped nearly 30 million in the last half of 1948 and about 50 million in the last months of 1949, however, as agricultural surpluses began to appear. Roughly 90 per cent of Seventh District CCC loans are made on corn crops. Because the volume of corn loans increases throughout the fall and spring before being taken over by the CCC in late summer, December figures on bank holdings do not give a clear picture of bank participation in the program. Nevertheless, the large and increasing end-of-year totals for CCC loans held by country banks in this District suggest that, until such time as the Federal support program is changed, this type of quasi-private agricultural paper will play an increasingly important role in country bank loan portfolios.

Real Estate Loans—Second to business loans in terms of loan volume held by District member banks, real estate loans outstanding as of December 31, 1949, amounted to 1.2 billion dollars. Central reserve city banks held only four per cent of this volume, while reserve city banks held 33 per cent. Country banks, whose mortgage holdings are the most important component in their loan portfolios, extended 63 per cent of the mortgage credit made available by District banks.

Loans on farm real estate account for only 78 million of the total mortgage credit extended by District banks. This type of credit has expanded slowly in the postwar period and still stands as an unusually small figure relative to farm incomes and farm asset values. Loans on "other" (largely commercial) properties, on the other hand, have more than doubled during the postwar period and now stand at 212 million. During the "reconversion" year of 1946 these loans increased 73 per cent in value, but in the ensuing years the annual increases have dropped to between 10 per cent and 15 per cent. Central reserve city banks actually reduced their loans on business properties over the postwar period, but because such banks hold less than 10 per cent of the District total of this type of credit, expanded lending on the part of reserve city and country banks more than offset this contraction.

Mortgages on residential properties, of course, account for the bulk of real estate credit extended by District member banks. At the end of 1949 these loans totaled 944 million, nearly two and one-half times greater than the volume outstanding in December 1945. The annual increases have tapered off sharply from the 50 per cent expansion of 1946, however, in contrast to the sustained nature of the housing boom. In 1949, when the nation as a whole built a record number of dwelling units, District member banks increased their volume of residential mortgages by only 7.5 per cent. Much of this slackening in growth during the past year can be traced to the widespread economic uncertainty and expectation for housing price declines which characterized the first six months of the year. Since the delayed upturn in construction which began in July, District member banks have increased real estate loans at a pace equal to that of 1948.

Consumer Loans—Rapid expansion in loans to con-



sumers has been one of the most important developments in banking since the end of the war. In the four years since December 31, 1945, outstanding consumer loans of District member banks have risen 280 per cent. As in all other types of private loan credit, the rate of increase slowed with each passing postwar year, but the 825 million dollars of consumer loans held by District banks at the end of 1949 still represented a 16 per cent increase over December 1948.

Central reserve city banks have been the least active participants in this field. They account for only about one-fifth of the total consumer credit extended by District member banks; after sizable increases in the first two postwar years, central reserve city banks actually reduced slightly their holdings of consumer loans during 1949. In country banks, on the other hand, consumer loans have surpassed commercial loans as the second largest type of bank loan credit and are continuing to grow substantially.

Instalment loans to finance retail automobile sales have been the most important factor in the postwar increase in consumer credit, particularly for country banks. Such loans by District banks have increased roughly 50 million dollars a year since 1945, with little slackening in 1949. The end-of-1949 total of 223 million in auto loans comprises nearly 30 per cent of the total consumer credit extended by District member banks.

Nonautomotive retail instalment paper held by District member banks declined during 1946 but rose sharply in 1947. The increases in this type of credit were progressively smaller in the following years, but by December 31, 1949, District member banks held 106 million of nonautomotive instalment loans. In contrast, consumer instalment loans for repair and modernization purposes have been expanded considerably in each postwar year. A 34 million growth in 1949, larger than in the previous year, raised District member bank holdings of this type of consumer paper to 137 million.

The least sustained increases in the consumer loan category have appeared in single-payment and instalment-payment cash loans. While large expansion in the early postwar years served to make cash loans the largest of any type of credit extension to consumers, District member banks by 1949 had reduced their annual rate of increase in cash loans to four per cent.

The very large and substantial relative expansion in consumer loans by District member banks is, of course, primarily a result of the low levels to which consumer lending dropped during the wartime period of high incomes and restricted spending. The total of all consumer credit is not yet abnormally high relative to disposable incomes, and the rapid expansion which from 1946 to 1948 added to inflationary pressures was in 1949 an important factor cushioning the economic readjustment.

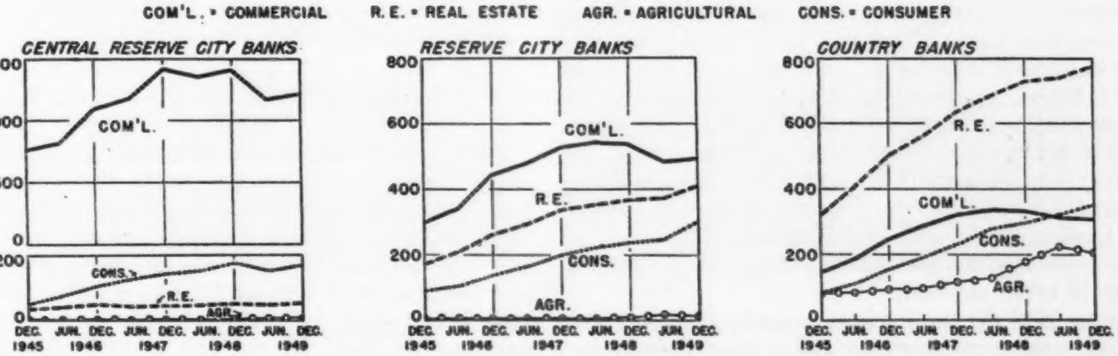
INVESTMENTS

By far the largest dollar volume of changes in bank asset portfolios since the war has occurred in U. S. Government securities holdings. Because of their liquidity, availability, and moderate earning power, Governments have, during the postwar period at least, come to supplant excess reserve balances as the "residual" or "adjustment" asset for most banks. The two major external demands for bank funds, from the viewpoint of an individual bank, come from private demands for loan credit and restrictive action on the part of the monetary and fiscal authorities. Depending upon the presence or absence of these two demands for bank funds, banks have sold or bought Government securities to equalize their reserve position. Because these two major demands for credit have waxed and waned together during the postwar period, changes in Government securities holdings of banks have been very large.

District member banks on December 31, 1945, held 12.1 billion of Government securities. During the ensuing year the upsurge in private demands for credit was accompanied by a large-scale withdrawal of unusually large United States Treasury balances from banks. Inasmuch as large banks held an important proportion both of Government balances and of the correspondent balances from which some country banks drew funds to meet a part of

LOAN TRENDS OF SEVENTH DISTRICT MEMBER BANKS
(IN MILLIONS OF DOLLARS)

COM'L. = COMMERCIAL R. E. = REAL ESTATE AGR. = AGRICULTURAL CONS. = CONSUMER



the demands, central reserve city banks accounted for 1.3 billion of the 2.3 billion decrease in District member bank holdings of Governments.

Continued private demands for loans led District country banks in particular to liquidate a moderate amount of Governments in 1947, and this trend continued through 1948. In addition, increases in member bank reserve requirements during 1948 forced additional sales of Governments. As a result, by the end of 1948 the Government securities holdings of central reserve city banks were reduced 38 per cent below the December 1945 volume, and those of reserve city and country banks were lowered 22 per cent and 15 per cent, respectively, below December 1945 levels.

During 1949, however, this pattern was sharply reversed. Economic uncertainties induced both a substantial slackening of private loan demand and expansionist Federal fiscal and monetary action. The Federal cash deficit added directly and indirectly to the supply of Government securities available for bank purchase, and three reductions in reserve requirements provided member banks with a large volume of investible funds. As a result of the 1949 reductions in member bank reserve requirements, Seventh District member banks were required to hold 633 million fewer reserves on December 31, 1949, than would have been the case under the reserve regulations in effect on December 31, 1948. Although each class of bank received a reduction of four percentage points in requirements, the tendency of country banks to redeposit a portion of the reserves thus freed in correspondent balances gave big urban banks a much larger relative volume of excess reserves. Accordingly, District central reserve city banks, which had borne the brunt of previous postwar adjustments, were able to increase their holdings of Governments by 691 million dollars, or 26 per cent, during 1949. Reserve city banks added 328 million, or 10 per cent, to their Government holdings during the year; and District country banks, after continuing their postwar pattern of net liquidation of Governments during the first half of 1949, increased their Government portfolios by 220 million during the remainder of the year.

In the meantime, District member banks were adding to their holdings other securities throughout the postwar period. Holdings of corporate debt were expanded only moderately to a total of 482 million by December 1949, but bank investment in obligations of states and political subdivisions rose by more than two-thirds during the four-year period. The bulk of the increase in holdings of state and local debt and of the 915 million total of such holdings at the end of 1949 was concentrated in District country banks.

On balance, total District member bank investments on December 31, 1949, were 11,675 million, 13 per cent above the total for the previous year, but 11 per cent below the figure for December 31, 1945. Substantial postwar loan expansion, however, raised the total of earning assets held to 16,232 million by the end of 1949. This total represents, for Seventh District member banks, the all-time peak in end-of-year earning asset volume.

DEVELOPMENTS IN BANK DEPOSITS

The shifting postwar movements in deposit liabilities of Seventh District member banks naturally parallel the movements in bank earning assets—an uneven decline during the postwar boom and a sharp upturn during the eased prosperity of 1949. Deposit movements also mirrored the growing importance of Federal fiscal and monetary action upon the banking system, for in every postwar year except 1947 changes in bank liabilities moved against the trends in private credit.

Gross deposits of Seventh District member banks totaled over 19 billion dollars on December 31, 1945. By the end of 1946 deposits had dropped 1.5 billion dollars, as a result of Treasury use of unusually large Government deposits to repay bank-held debt. In absorbing the major portion of this decline, central reserve city banks lost 1.1 billion, or one-sixth, of their total deposits. In the following year the strong upward pressures in private demands for credit overrode the moderate fiscal and monetary restraining action, and District member banks recovered 1.2 billion of the deposit loss of the previous year. Central reserve city banks expanded deposits a little more, and country banks a little less, than the District average of seven per cent.

During 1948 the slowing loan expansion, coupled with increased reserve requirements and a large Federal surplus used to reduce bank-held debt, held the total deposits of each class of bank close to their previous year's levels. In the economic readjustment of 1949, however, "easy money" policies on the part of the central bank and the appearance of a sizable Federal deficit enabled District member banks to boost total deposits by nearly one billion dollars. Most of the increase centered in the District's central reserve city banks, which were able to raise their total deposits to 6.8 billion dollars, within three per cent of their total in December 1945. Progressively smaller increases during the year were experienced by reserve city and country banks, but the growth of earlier years helped to raise total deposits in these classes of banks above their 1945 figures by six per cent and nine per cent, respectively.

DEPOSITS OF INDIVIDUALS AND BUSINESSES

While trends in total deposits are important to bankers in setting portfolio policy, it is the changes in the money supply owned by individuals and businesses which affect and reflect regional economic activity. In this category the demand deposits of individuals, partnerships, and corporations in Seventh District member banks have risen substantially and fairly steadily in the four years following the war. At the end of 1949 these deposits totaled 10.7 billion dollars, two billion above the Decem-

ber 1945 figure. The most important factor influencing this growth was the large and sustained postwar bank loan expansion, but other factors intervened to produce significant differences among deposit-holders and classes of banks during the period.

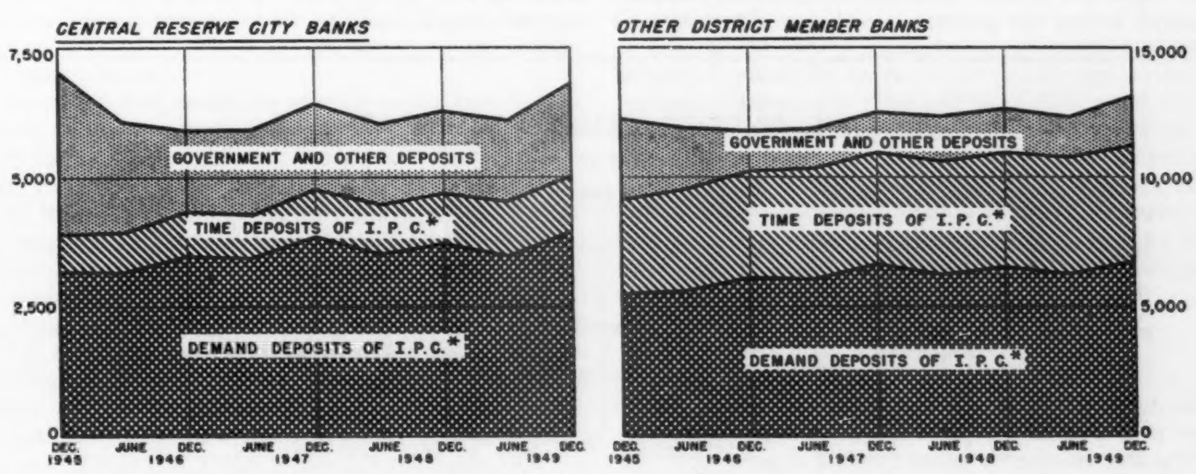
The largest single annual increase in these private deposits occurred in 1946, when rapid business loan expansion and Treasury retirement of Government securities held outside the banking system raised private deposits one billion dollars above the total for the end of 1945. Because of considerable growth in personal deposits, particularly those of farmers, country banks obtained the major portion of this increase. In central reserve city and reserve city banks an increase in demand balances of construction and service trades, retailers, and individuals was partially offset by declines in balances of manufacturing concerns engaged in heavy capital spending programs. The year 1947 brought another 850 million dollar increase in private demand deposits, as sharp rises in manufacturers' balances counter-balanced the slackening in the growth of personal deposits. High profits and needs for larger working balances during the boom induced manufacturers, wholesalers, and retailers to increase their balances considerably. Consequently, private demand deposits in central reserve city banks increased over 10 per cent during the year. Much the same factors helped to raise these deposits in reserve city banks by 9.5 per cent; but the tapering growth in personal deposits, particularly for farmers, held the rate of increase in country banks somewhat lower.

By the end of 1948 sharply curtailed loan expansion was diffusing fewer new funds throughout the private economy. This fact, coupled with the Federal budget surplus used to reduce bank-held Government debt, produced a slight decline in the total of Seventh District demand deposits owned by individuals, partnerships, and corporations. Of the major types of deposit-holders only nonprofit associations, insurance companies, and construction and service trades effected an appreciable increase in demand balances. Farmers' balances, meanwhile, fell off quite sharply under the dual pressures of falling farm prices and rising current and capital expenditures. The growing tendency in large banks to move trust fund deposits into time accounts furthered the demand deposit decline during 1948. The net result of these trends was to reduce moderately private demand deposits in all except reserve city banks.

The period of monetary ease characterizing 1949 induced a 400 million dollar expansion in private demand deposits of District member banks. The deposit growth, due largely to direct and indirect Government securities sales to the banking system, centered in the larger cities. Deposits of individuals showed little net change over the year, as gains in urban personal deposits were offset by further sizable reductions in the demand balances of farmers. Businesses, however, added appreciably to their stock of bank money. Manufacturing and mining firms increased their deposit holdings over six per cent during 1949, and public utilities, transportation, and communication concerns increased deposits by over seven per cent. The largest relative increase in deposits (over 12 per cent) was reported for the construction and service trades, probably due in part to the record building activity of last year. Wholesalers, retailers, and insurance companies, however, increased demand balances by only 2.6 per cent. Other financial business effected a five per cent addition to their accounts. On the whole, the eased prosperity of 1949 was accompanied by a slight relative shift

DEPOSIT MOVEMENTS IN SEVENTH DISTRICT MEMBER BANKS

(IN MILLIONS OF DOLLARS)



* INDIVIDUALS, PARTNERSHIPS, AND CORPORATIONS.

of cash funds to nonfinancial businesses, particularly manufacturers, public service concerns, and the construction and service trades.

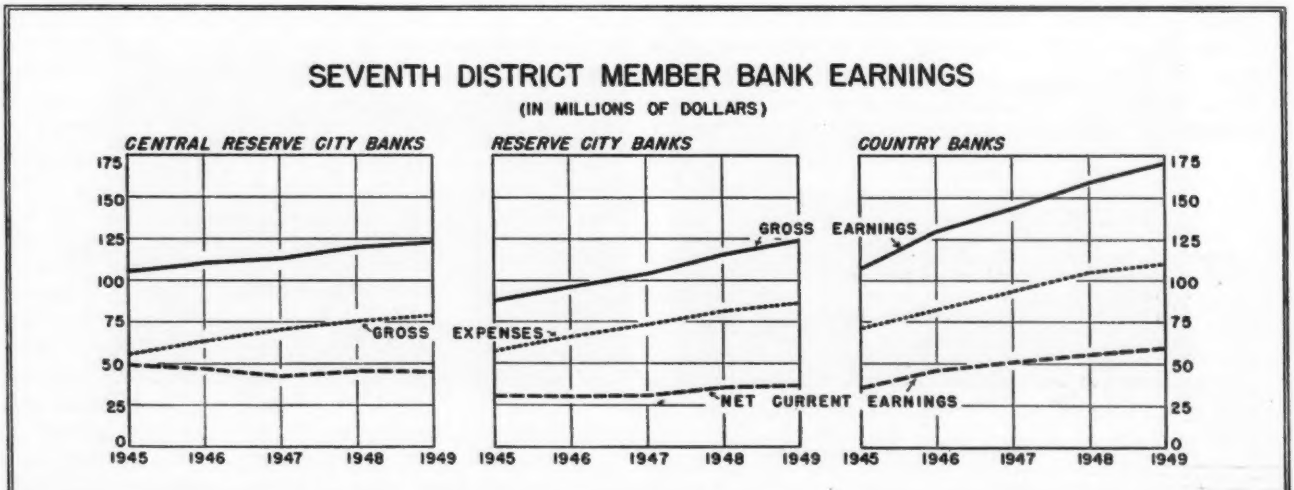
In general, at the end of the four years of postwar inflation all but one of the important types of deposit-holders in the Seventh District held a substantially larger volume of bank money. Bank accounts of individuals, which amount to one-third of total District private demand deposits, increased over 18 per cent between January 31, 1946, and January 31, 1950. The deposits of manufacturing and mining concerns, which comprise an additional one-fourth of District private demand deposits, rose 17 per cent during the same period. Accounts owned by nonbank financial institutions grew by nearly 35 per cent; those of nonprofit associations expanded 30 per cent; deposits of construction and service trades rose by more than 35 per cent; and balances of retailers and wholesalers increased by 18 per cent over these four years. Only the deposits of public utilities and transportation and communication concerns did not rise during the inflation; higher costs and large capital spending programs helped to hold their balances on January 31, 1950, three per cent below the total for January 31, 1946. For the private economy in general, however, the high profits, savings, and working capital needs accompanying the inflationary prosperity involved considerable net demand for new private demand deposits. On balance, bank loan expansion and transfers from U. S. Government demand balances provided the requisite supply.

The postwar growth in private demand deposits was diffused very evenly throughout the Seventh District. Each class of member bank closely approximated the average District growth of 19 per cent between the end of 1945 and the end of 1948. In the readjustment of 1949, however, the 400 million dollar District increase in deposits of individuals, partnerships, and corporations was concentrated entirely in central reserve city and reserve city banks. New private deposits created during the period resulted largely from bank purchases of Government securities either from nonbank investments or directly from the Treasury. The accumulation and spending of these new deposits centered primarily in the larger cities, and as a consequence reserve city and central reserve city banks experienced a six per cent increase in private demand deposits.

During the entire postwar period, meanwhile, District time deposits owned by individuals, partnerships, and corporations were expanding steadily, although at a decreasing rate of increase. The three per cent increase in such deposits during 1949 raised the District total for private time deposits to 5.5 billion, 26 per cent above the 1945 figure. The practice of switching bank trust funds from demand deposits to time deposits contributed to a larger and more sustained growth of private time deposits in central reserve city banks. On December 31, 1949, time deposits in these banks were 49 per cent above 1945 levels. For reserve city and country banks, where the major influence was the rate of accumulation of private savings, private time deposits grew by 22 per cent and 20 per cent, respectively, from 1945 through 1949.

INCOME, COSTS, AND PROFITABILITY

For Seventh District member banks the years 1945-49 were a period of steadily increasing earning power. Despite the shrinkage in total earning assets between 1945 and 1948, District banks in each postwar year substantially increased their gross current operating earnings. A more rapid rate of increase in current operating expenses occurred during the postwar period, but the volume of the increase in expenses was not large enough to offset the growth in gross earnings. Consequently, net current operating earnings also increased in each year since the war. For the year 1949, gross operating earnings of member banks totaled 417 million dollars, 39 per cent higher than the 1945 figure. The 1949 total of current operating expenses was 276 million, 49 per cent above the 1945 fig-



ure, and the 1949 total of 142 million in net current operating earnings was 22 per cent above 1945. For each of these items the 1949 total represents the all-time peak for Seventh District banking.

INCOME

Interest on Governments—In 1945 District banks obtained over one-half of their total operating income from interest payments on their holdings of U.S. Government securities. By 1949 this fraction was reduced to somewhat over one-third, as postwar loan expansion and liquidation of Governments reduced, both relatively and absolutely, the importance of Governments in the Seventh District earnings picture.

The shift in earnings on Governments varied considerably between years and between classes of banks. During 1946 total District member bank earnings from this type of investment actually rose nine million. Heavy deposit drains forced sufficient liquidation of Governments on central reserve city and reserve city banks to hold their earnings on Governments close to 1945 levels, but shifts in Government holdings from short-terms to long-terms enabled country banks to increase earnings on Governments by 19 per cent. In the two ensuing years net liquidation of Government securities and shifts from long-term to short-term issues more than offset the effects of a rising interest rate pattern. As a result, earnings on Governments dropped nearly 18 million between 1946 and 1948. Central reserve city banks, in absorbing half of this decrease, experienced a 16 per cent drop in the interest received on Governments.

The reversal in the trend of net liquidation of Government security holdings which appeared in 1949 had its concomitant in a 3.6 million increase in interest earned on Governments by District banks. The effect on earnings of declining interest rates was more than counterbalanced by large bank purchases of Government securities with funds released by reserve requirement reductions. Of the three classes of banks only country banks failed to share in the increase in earnings, largely because of their delayed switch from net selling to net buying of Treasury issues.

Over the whole period the average annual interest rate earned on Governments by the typical District member bank increased from 1.5 to 1.7 per cent. Early postwar shifts from short-term to long-term holdings by country banks influenced this average rate rise and helped country members to increase their earnings on Governments by nearly four million dollars between 1945 and 1949. Yet because of the sizable net reduction in Government holdings, concentrated particularly in central reserve city banks, total earnings on these securities for all District member banks declined from 155 million to 150 million during the four postwar years.

Interest on Loans—The most important factor in the postwar increase in District member bank earnings has been the rapid increase in interest and discounts on loans. Since 1945 earnings on loans have increased 140 per cent to a 1949 total of 171 million.

During each of the first three years after the end of the war, loan earnings for each class of bank increased sizably and steadily. The year during which the greatest proportional increase occurred was 1947, but the rate of gain was only moderately lower during 1948. The year 1949, however, brought a slowing of the rate of increase in this type of earnings, especially during the first half of the year. The fall-off in business borrowing in central reserve city banks cut their income from lending operations by two per cent. Continued demand for loan credit at District country banks, on the other hand, enabled them to add well over nine million dollars to their loan earnings in 1949. While this addition was only two-thirds of the average annual growth since the war, it represented a 13 per cent increase in country bank loan income. Reserve city banks, meanwhile, experienced an eight per cent increase in loan earnings over the year.

The typical member bank within the Seventh District earned 4.9 per cent average annual interest on loans for the first three postwar years and experienced a one-tenth of one per cent rise in this rate of return during 1949. Country banks, which most closely resemble the statistically "typical" District bank, combined this high yield with large loan expansion to boost their total earnings from loans by 182 per cent between 1945 and 1949. By 1949 loans were producing almost half again as much income for these banks as were Government securities. For both the other classes of banks loan income remained slightly below income on Government securities, although central reserve city banks and reserve city banks increased their earnings on loans by 85 per cent and 142 per cent, respectively, in the four years after the war.

Other Current Earnings—Earnings on securities other than those of the United States Government held relatively stable in the first three postwar years. In central reserve city and country banks such earnings actually declined somewhat in 1946. During 1948 and 1949, however, earnings on "other" securities rose by approximately one-fourth for all classes of banks, largely because of increased holdings of long-term bonds of state and local Governments.

One of the newer methods for obtaining additional earnings has been the levying of service charges on deposit accounts. Increases in rates and more widespread utilization have steadily increased the yield from this source for all classes of District banks. In 1949 service charges provided over 21 million in income to District banks, sixty-two per cent more than in 1945. For both reserve city and country banks service charges have now become more important as a source of income than their holdings of state, local, and corporate securities.

EXPENSES

Salaries—As is usual with service institutions, salary costs represent the largest single expense item in banking. For Seventh District banks all salaries averaged between 40 per cent and 45 per cent of all current operating costs during the postwar period. Moreover, the total salary bill of banks increased somewhat more rapidly than

remaining operating expenses during the period; the combined figure for officers' and employees' salaries rose 61 per cent from 1945 to 1949.

A steady although gradually slackening growth in employees' salaries has been characteristic of the postwar period. For each class of bank the increase in this expense during 1946 was over 20 per cent, and annual increases were only moderately smaller in 1947 and 1948. In 1949, however, central reserve city banks were able to hold employee salary costs at the level reached in the previous year, although such costs at reserve city and country banks rose somewhat more than seven per cent.

An equally steady, though smaller, growth occurred in officers' salaries over the period. The 16 per cent annual rate of growth in this item in 1946 tapered off slowly in the following years, with the exception of a slight upturn in the rate of increase in officers' salaries in reserve city banks in 1948 and 1949. By 1949 District banks in general were increasing the total of salaries for officers at an annual rate of eight per cent.

By and large, the trend in salary costs of District banks was fairly uniform. The initially larger if less sustained increase in employees' salaries as compared with officers' salaries, however, did lower slightly the general ratios between officers' salaries and employees' salaries to about one-third for reserve city banks, two-fifths for central reserve city banks, and four-fifths for country banks.

Other Current Expenses—The largest single cost other than salaries for District banks is interest paid on time deposits. Such interest payments rose from 34 million to 48 million between 1945 and 1949, due more to the growth in volume of time deposits than to increases in interest rates offered. Most of the 40 per cent expansion in interest payments came in the early postwar years when time deposits were gaining substantially. On the other hand, the moderate five per cent annual rise in this payment in 1948 and 1949 was primarily the result of higher time deposit interest rates. Throughout the period increases in interest rates offered were most common among country banks, while central reserve city banks enjoyed by far the largest growth in time deposits. Consequently, the 1945-49 rise in time deposit interest payments for these two classes of banks was half again as great as the 31 per cent increase for reserve city banks.

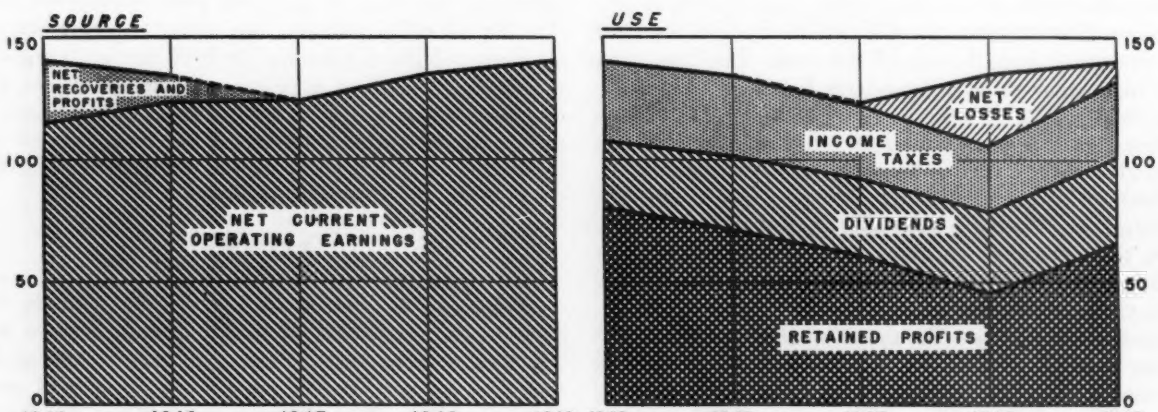
A fairly steady rise in other current expenses contributed to the sizable but gradually slackening upward trend in total current operating expenses of District member banks. The average District pattern of increase, from a 14.6 per cent rise in 1946 down to a 6.0 per cent rise in 1949, was almost exactly matched by reserve city banks, with the growth in central reserve city banks' operating expenses uniformly a little below this trend and the increase for country banks somewhat higher than the average.

LOSSES AND RECOVERIES

Postwar developments have produced an unusual amount of variation in the nonoperating accounts of commercial banks. Net losses and recoveries of District banks have varied from an addition to earnings of 25 million in 1945 to a net subtraction from earnings of 30 million in 1948. In spite of the fact that most of the activity in these accounts is of a "bookkeeping" nature, postwar changes on balance have resulted in a substantial reduction in reported net profits and income taxes and in a "hidden" strengthening of capital position by means of increased reserves.

For most District banks a steady postwar decline in losses on securities was regularly exceeded by reductions in recoveries and profits from sales of securities between 1945 and 1948. In the latter year securities losses had come to exceed securities profits by 2.5 million dollars. During 1949, however, an upturn in recoveries and profits on investments, particularly in central reserve city banks,

SOURCE AND USE OF NET EARNINGS OF SEVENTH DISTRICT MEMBER BANKS
(IN MILLIONS OF DOLLARS)



enabled District banks to show a ten million dollar capital profit on securities portfolios.

In loan portfolio operations the 1947 ruling of the Bureau of Internal Revenue allowing additions to bad debt valuation reserves as income tax deductions had a pronounced effect on bank accounting practices.[1] From a 1946 year-end balance of 7.5 million, District member banks increased their loan valuation reserves by approximately three million in 1947, 32 million in 1948, and 15 million in 1949. Because these transfers were made from current earnings, they reduced net profit figures correspondingly for the more than 500 District member banks which had established these reserves by December 31, 1949.

Because of the accounting technicalities involved, it is impossible to determine accurately the actual net losses (or recoveries), exclusive of bad debt reserve additions, on loans of District banks during the period. Nevertheless, estimates indicate that member bank loan losses have moved speedily toward a more normal volume relative to total loans during the years following the war. In 1945 District banks experienced 3.5 million net recoveries on loans. By 1947 and 1948, actual charge-offs were exceeding loan recoveries by over two million dollars annually, and indications are that the net excess of actual charge-offs during 1949 was close to five million, roughly one-tenth of one per cent of total District loans. Most of the increases in net losses seem to have occurred in country banks, although net losses increased in both reserve city and central reserve city banks in the later postwar years.

TESTS OF PROFITABILITY

Although net profits after taxes—the conventional measure of the profitability of an industry—show a declining postwar trend for commercial banking, this item is not a dependable criterion of the prosperity of Seventh District banks in this period. To obtain tax credits, District banks between 1947 and 1949 made gross additions to bad debt reserves roughly six times larger than the actual losses suffered. This "bookkeeping" action alone, although representing no real expense to the banks, reduced "reported" net profits for the three years by nearly one-fifth. Thus, due to the shift from net gains to net losses in nonoperating income accounts, District member banks reported increasingly larger reductions in net profits after taxes between 1945 and 1948.

The three-year decline of 27 per cent in District banking net profits was not spread evenly over the various classes of banks. Net profits of reserve city banks were halved during the period, while country bank profits declined only 14 per cent from 1945 to 1948. Likewise, the sharp increase in reported net profits in 1949 was unevenly spread, with the greatest rise centered in central reserve city banks. The 1949 rise was sufficient, however, to raise both central reserve city and country bank net profits back above their 1945 levels, although 1949 profits of reserve city banks were still one-third lower than in 1945. Member bank net profits in 1949 aggregated 101 million dollars, which for the typical District bank represents a 10.2 per cent return on total capital.

In contrast to the trend in net profits, returns to stockholders in District banks were raised steadily throughout the postwar period. Cash dividends declared on common stock rose to over 35 million in 1949, 30 per cent above the 1945 payments. Country banks were the most generous with their shareholders, raising common stock dividends 17 per cent between 1946 and 1948 at a time when central reserve city banks were holding their dividend payments stable. All classes of banks, however, increased common stock dividends declared between eight per cent and nine per cent during 1949. Nevertheless, because of a general tendency in District banks to retain roughly two-thirds of net profits as additional capital, annual common stock dividends declared by the typical bank averaged a 2.8 per cent return on total capital throughout this period.

Because of the extraordinary tax-allowed bad debt deductions and the general tendency to reinvest a large share of bank earnings, however, both "net profits after taxes" and "cash dividends on common stock" are poor reflectors of District bank profitability in the postwar period. The core of any bank's earning power must be considered to be its ability to report net operating earnings on a current basis. In this category Seventh District banks reported divergent movements during the postwar years.

The year 1948 brought the largest postwar increase in net operating earnings for District member banks, and it was only during this year that central reserve city banks were able to show an increase in this figure. Net operating earnings of central reserve city banks declined 13 per cent between 1945 and 1947, and another decline of one per cent between 1948 and 1949 held their net current earnings during last year to 45 million, nine per cent below the 1945 level. Reserve city banks, after a slight decline in net operating earnings in 1946, were able to increase their earnings sufficiently in succeeding years (including a six per cent increase in 1949) to raise their 1949 figure 21 per cent above the 1945 total. Country banks, on the other hand, were able to increase net operating earnings by 30 per cent in 1946 alone, and in succeeding years experienced further increases in such earnings. Due largely to their loan expansion, the net operating earnings of District country banks in 1949 were over 59 million, 66 per cent above 1945.

For all District member banks in general the 4.1 per cent expansion in net operating earnings in 1949 was less than one-half of the high rate of growth attained at the peak of the postwar inflation in 1948. As a result, the 142 million in net operating earnings during 1949 represented for the typical District bank a 15.1 per cent return on total capital, one-tenth of one percentage point less than in 1948. Nevertheless, District banking operations during 1949 enabled the average member bank to retain almost completely the 20 per cent increase in "profitability"—measured in terms of ratio of net current operating earnings to total capital acocunts—which was achieved during the first three years of postwar prosperity.

[1] For a detailed discussion of this ruling, see *Business Conditions*, March 1949.

SEVENTH FEDERAL

RESERVE DISTRICT